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No. OFFICE OF THE CLERK

In The
Supreme Court of the United States

HOWARD GREENBERG,
Petitioner,

v.

BEAR, STEARNS & CO.,
BEAR STEARNS & CO., INC.,
BEAR STEARNS SECURITIES CORP.,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR WRIT OF CERTIORARI

LESLIE TRAGER
Counsel of Record
MORLEY AND TRAGER
230 PARK AVENUE
NEW YORK, NY 10169
(212) 684-2210

Counsel for Petitioner

BECKER GALLAGHER LEGAL PUBLISHING, INC.,
CINCINNATI, OHIO 800-890-5001

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QUESTIONS PRESENTED

1. What shall be the standard for reviewing cases arising under the federal securities acts in order to insure that rights under the securities laws are recognized in an arbitration?

2. If manifest disregard of the law is to be standard, was the Second Circuit correct in holding that the arbitrators had not manifestly disregarded the law by:

   a. not imputing knowledge of the admittedly fraudulent scheme to respondent Bear Stearns when the undisputed evidence showed that Bear Stearns management admitted reading the first and second sentences of the one applicable paragraph on page 2 of a prospectus but could not "recall" reading the third sentence which would have admittedly informed Bear Stearns of the fraudulent scheme?

   b. not imposing liability upon Bear Stearns pursuant to Section 12a(1) of the Securities Act of 1933 for failing to send a prospectus on an underwriting?

PARTIES TO THE PROCEEDING

Petitioner

Howard Greenberg

Petitioner is an individual and has no corporate affiliations.

Respondents

Bear Stearns & Co.

Bear Stearns & Co., Inc.

Bear Stearns Securities Corp.

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The opinions of the Second Circuit, 220 F.3d 22, and the district court are reprinted in the appendix commencing at page 1a.

JURISDICTION

Petitioner filed a petition in the United States District Court, Southern District of New York alleging that the arbitrators at the NASD had disregarded the securities laws to wit: the Securities Exchange Act of 1934, Section 10(b) and the Securities Act of 1933, Section 12(a)(1) and asking that the award be vacated. Jurisdiction existed because federal questions were raised by the petition pursuant to 28 U.S.C. § 1331.

The District Court denied petitioner's claims (Appendix, p. 15a) and petitioner appealed to the Court of Appeals for the Second Circuit. On August 7, 2000, the decision of the District Court was affirmed. The Second Circuit held that the federal courts had jurisdiction over the petition to vacate the arbitration award because federal jurisdiction will "lie if the ultimate disposition of the matter by the federal court 'necessarily depends on resolution of a substantial question of federal law'" and that the petitioner here complains "in good faith that the award was rendered in manifest disregard of federal law...." (pp. 7a and 9a of appendix).

Pursuant to Supreme Court Rule 13.1, this petition has been filed within 90 days of the Second Circuit Opinion and is, therefore, timely. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED IN THIS CASE

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange –
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, 17 CFR § 240.10b-5:

> "It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud.
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact

necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any fact, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Securities Act of 1933, 15 U.S.C. 77e(b)(1):

"It shall be unlawful for any person, directly or indirectly --

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title."

Securities Exchange Act of 1933, Section 12(a)(1), 15 U.S.C. 77l(a)(1):

"(a) In general

Any person who --

(1) offers or sells a security in violation of section 77e of this title

* * *

shall be liable, subject to subsection (b) of this section, to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security."

17 CFR § 230.174(d):

"(d) If (1) the registration statement relates to the security of an issuer that is not subject, immediately prior to the time of filing the registration statement, to the reporting requirements of section 13 or 15(d) of the Securities Exchange Act of 1934, and (2) as of the offering date, the security is listed on a registered national securities exchange or authorized for inclusion in an electronic inter-dealer quotation system sponsored and governed by the rules of a registered securities association, no prospectus need be delivered after the expiration of twenty-five calendar days after the offering date. For purposes of this provision, the term *offering date* refers to the later of the effective date of the registration statement or the first date on which the security was bona fide offered to the public."

STATEMENT OF THE CASE

The undisputed evidence at the arbitration showed that a Bear Stearns' senior officer had read the first two sentences of the one applicable paragraph found at page 2 of a prospectus, but could not "recall" reading the third and fifth sentences of this one paragraph. The latter two sentences would have informed Bear Stearns beyond per adventure of doubt that Bear Stearns would be engaging in major fraud if it did the proposed underwriting. Petitioner claimed that knowledge of these sentences under these circumstances must be imputed to Bear Stearns. The Second Circuit's sole statement with respect to this read:

> "The petitioner argues that Bear Stearns should be deemed to have knowledge of the fraud because it had the necessary information before it, but it is by no means clear that the doctrine of imputed knowledge applies in this context." (Appendix p. 12a)

No cases, authority or reasoning were given to support this. The Second Circuit agreed that "knowing participation in a fraudulent scheme may render a participant liable under Section 10(b)" citing S.E.C. v. United States Environmental Inc., 155 F.3d 107, 111 (2d Cir. 1998), cert. den. sub nom. Romano v. S.E.C., 526 U.S. 1111, 119 S.Ct. 1755 (1999).

The undisputed facts showed the following: In August, 1996, Bear Stearns was requested by its introducing broker, Sterling Foster, for whom it cleared, to clear an underwriting of a most unusual sort in which Sterling Foster would sell 2.4 million shares of common stock of a company short after the initial offering by another firm of a separate 1.1 million shares and cover that 2.4 million short sale with stock from

inside selling shareholders. Concededly, the sale of stock from insiders constituted an underwriting. Thus, Bear Stearns knew in August, 1996 that there would be an underwriting in which stock of the inside shareholders would be sold immediately after the initial offering. Prompt covering was necessary in order to prevent Bear Stearns from being exposed to the unlimited risk of a short sale - that the price would rise above the sale price.

Bear Stearns' associate managing director requested and received a preliminary prospectus, which insofar as this matter is concerned was identical to the final prospectus. Page 2 of this preliminary prospectus contained the only paragraph relevant in the prospectus to the issuance of the inside selling shareholders' shares. This paragraph read as follows:

> "Also, the registration statement of which this Prospectus forms a part covers the offering of 2,400,000 shares of Common Stock, 2,000,000 Class A Warrants and 2,000,000 shares of Common Stock underlying Class A Warrants owned by certain affiliated and non-affiliated persons, hereinafter collectively referred to as the 'Selling Securityholders'. *The Company will not receive any of the proceeds on the sale of the securities by the Selling Securityholders*. The securities held by the Selling Securityholders may be sold commencing 12 months from the date of this Prospectus, subject to earlier release at the sole discretion of Patterson Travis, Inc., the representative (the 'Representative') of the underwriters of this offer (the 'Underwriters'). The Representative may release the securities

held by the Selling Securityholders at any time after all securities subject to the Over-Allotment Option have been sold or such option has expired. The Representative has no agreements or understandings with any of the Selling Securityholders with respect to release of the securities prior to the respective periods and has no present intention of releasing any or all of such securities prior to such periods." (emphasis added)

For clarity, the first three sentences have been done in different type.

This associate managing director admitted reading the first two sentences but couldn't recall reading the third sentence, which clearly says that these insider shares can be sold only after 12 months from the date of the prospectus (the initial offering). The fifth sentence says that there are "no agreements or understandings" to release the securities prior to that 12-month period. Thus, these statements (the lockup) directly contradicted the information represented to this associate managing director that there would be a sale of these securities immediately following the IPO.

This same one paragraph was delivered to the managing director and number 2 person at the Bear Stearns clearing operation and to a Bear Stearns' attorney who then prepared a separate guaranty agreement by Sterling Foster's President directly relating to this sale by the inside selling shareholders. But the number 2 managing director testified that he too couldn't "recall" anything about a lockup. The attorney, though requested to testify by petitioner, was not directed to testify by the arbitrators.

For this very fraud, the officers of Sterling Foster pled guilty to criminal securities fraud charges while this arbitration was pending and this fact was brought to the attention of the arbitrators.

Petitioner lost approximately half a million dollars on this fraudulent scheme under which Sterling Foster, clearing through Bear Stearns, distributed not the 1.1 million shares set forth in the prospectus, but three times that number or 3.5 million shares.

Sterling Foster paid $3.25 for these insider shares and sold to the public at prices ranging from $13.25 to over $15 per share for a 400% profit of approximately $24 million. The public lost approximately $50 million.

In addition, Bear Stearns, as the clearing agent for Sterling Foster, handled the payment to the insiders on behalf of Sterling Foster and mailed confirmations to Sterling Foster's customers. It is illegal under the Securities Act of 1933 to mail a confirmation within 25 days of an underwriting without also mailing to the customer a prospectus. Failure to do so allows rescission under Section 12(a)(1) of the Securities Act of 1933. No prospectus, however, was mailed to the customers.

The confirmations mailed by Bear Stearns stated that Sterling Foster made a market in the relevant stock. It did not disclose that in fact these transactions were part of an underwriting, not market making, nor that Sterling Foster made a 400% profit. Admittedly, Bear Stearns knew that this was an underwriting.

Thus, this fraudulent transaction was handled by Bear Stearns as though the securities laws did not exist. Yet, the

NASD arbitrators found in favor of Bear Stearns by dismissing at the end of petitioner's case. No reasons were stated.

The Court of Appeals held that such disregard of the securities acts did not constitute "manifest disregard" of the securities acts and, therefore, upheld the arbitrators.

REASONS FOR GRANTING THE WRIT

This Court in Shearson/American Express v. McMahon, 482 U.S. 220, 232 107 S.Ct. 2332, 2340 (1987), in holding that claims under the 1934 Securities Act could be arbitrated, held:

> "[A]lthough judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to insure that arbitrators comply with the requirements of the statute."

This is a promise which to date has not been kept. Today, the courts virtually always defer to the arbitrators even where the undisputed facts demonstrate violations of the securities acts as a matter of law. While some courts claim to review arbitration awards for "manifest disregard of the law", as one commentator stated:

> "The current formulation of manifest disregard of the law certainly lacks potency. Indeed, one must question whether it actually affords any protection beyond that provided in the arbitration statutes.... Manifest disregard of the law remains an illusive concept that can be understood better in terms of what it is not, rather than what it is." Levin, *The Role of*

Substantive Law in Business Arbitration and the Importance of Volition, 35 American Business L.J. 105, 149 (Fall 1997).

Indeed, the "manifest disregard" standard is applied by the courts not just to federal statutory claims, but to non-statutory cases, as well. See In re Carte Blanche (Singapore) PTE, Ltd., 888 F.2d 260, 267 (2d Cir. 1989). It is applied to those who have truly voluntarily agreed to arbitration and to those where industry-wide, and virtually universal practice, forces the weaker party into an industry-controlled arbitration. It is the latter case which prevails in the securities industry today. As Levin, supra, points out, it is unfair to treat those who truly voluntarily give up their rights to go to court for arbitration the same as those who did not and for the latter "there must be additional emphasis... on providing awards in accordance with law." (Id. at 174).

The Fifth Circuit does not even recognize the vague concept of manifest disregard. Gulf Coast Funds Workers Union v. Exxon Co., 991 F.2d 244 (5th Cir.) cert. den. 510 U.S. 965, 114 S.Ct. 441 (1993). The 11th Circuit applied it reluctantly only when respondent's attorney urged the arbitrators to disregard statutory law. Montes v. Shearson Lehman Bros., 128 F.3d 1456 (11th Cir. 1997). Indeed, one commentator compared the Second Circuit case of Halligan v. Piper Jaffe, Inc., 148 F.3d 197 (2d Cir. 1998) cert. den. 526 U.S. 1034, 119 S.Ct. 1286, to DiRussa v. Dean Witter Reynolds, Inc., 121 F.3d 818 (2d Cir. 1997) and noted that "the Halligan court did not clearly identify the law that it believed the arbitrators disregarded" and that Halligan involved a far more complex area of the law than DiRussa. Poser, *Judicial Review of Arbitration Awards: Manifest Disregard of the Law*, 64 Brooklyn L. Rev. 471, 479, Summer 1998. Yet, the court in DiRussa did not overturn the

arbitrators' refusal to award attorneys' fees to the victorious plaintiff under Title VII, to which the claimant was clearly entitled. This commentator called for a standard in which an award will be vacated "if the arbitrators deny a claimant statutory rights to which he or she is entitled." Poser, id. at 514.

Prior to Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477, 109 S.Ct. 1917 (1989) and Shearson/American Express v. McMahon, 482 U.S. 220, 107 S.Ct. 2332 (1987) pre-dispute agreements to arbitrate claims under the securities acts were invalid because the "power to vacate an award is limited" and "the provisions of the Securities Act... effectiveness in application is lessened in arbitration as compared to judicial proceedings." Wilko v. Swan, 346 U.S. 427, 435, 436, 74 S.Ct. 182 (1953).

> In overruling Wilko, this Court held:
> "Our conclusion is reinforced by our assessment that resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioner under the Securities Act." Rodriguez de Quijas at 490 U.S. 485, 486.

But today, that confidence is in doubt and this Court has not ruled how in fact rights under the securities acts are to be protected. Protecting such rights is particularly important where the

> "NASD pool of arbitrators tends to be composed largely of retired persons and full-time professional arbitrators... who... may be subject to subtle pressures if a significant portion of their livelihood depends on that

> activity...[for] if an arbitrator decides too many cases adversely to brokerage firms, he or she is likely to be challenged peremptorily by brokerage firms in future cases." Poser, *Judicial Review of Arbitration Awards: Manifest Disregard of the Law*, 64 Brooklyn L.R. 471, 500, Summer 1998.

This is not simply a commentator's hypothetical fears, for a study by the Public Investors Arbitration Bar Association (PIABA *Evident Partiality Study [prelim]*) showed that even after Prudential-Bache Securities had been found by the SEC to have violated the anti-fraud statutes and had a fine of $10 million imposed by the SEC, $5 million by the NASD, $27.5 million by the states and agreed to a restitution fund of $336 million, in 29 out of 69 cases (43%) arbitrators from the Pacific Stock Exchange found against the investor in cases involving claims against Prudential-Bache arising out of the same fraudulent transactions. In all cases, the arbitrators who found against the investors were either professional arbitrators or were formerly associated with the securities industry.

Indeed, the securities industry itself recognizes that the SRO controlled arbitration forums such as the NASD favor the industry because when the courts allowed customer arbitrations to be brought before the American Arbitration Association through the so-called AMEX window, the American Stock Exchange immediately changed its constitution to prevent customers from using a non-SRO controlled forum. See Cowen & Co. v. Anderson, 76 N.Y.2d 318, 558 N.E.2d 27 (1990); Gregory and Schneider, *Securities Arbitration: A Need for Continued Reform*, 17 Nova L.R. 1223, 1243 (1993).

In such a setting, it is particularly important that the rights of investors under the Federal Securities Acts be protected by effective judicial review. As Gregory and Schneider, supra, stated:

> "If the Supreme Court has removed the investor's judicial remedy, the arbitration substituted for it should be fashioned in such a manner that the remedy is meaningful."
>
> x x x
>
> The fairness of our judicial systems is predicated on openness, impartiality and appellate review. Securities arbitration in its current repute fails in these important aspects." (id. at 1250).

The Connecticut Supreme Court stated:

> "Judicial approval of arbitration decisions that so egregiously depart from established law that they border on the irrational would undermine society's confidence in the legitimacy of the arbitration process." Garrity v. McCaskey, 612 A.2d 742, 747-48 (Conn. 1992).

Here, the undisputed facts demonstrate an irrational decision, upheld only by stretching the concept of rationality beyond the breaking point. Thus, the case at bar presents the general question as to what the standard of review should be for arbitration of securities act cases. The second question sets forth some of the precise issues of law ignored by the arbitrators under the securities acts.

In this case, the facts are simple and undisputed. Bear Stearns received a proposed prospectus which had one relevant paragraph on page 2. This paragraph and page was read, or sent to at least three people to read, who focused on that paragraph - an associate managing director, an attorney who drafted a special, guarantee agreement by Sterling Foster's President for the transaction, and the number 2 person at the clearing arm of Bear Stearns. Anyone reading the third sentence in that paragraph would immediately know that there was a massive fraud being perpetrated for that paragraph represented that there was a lockup of the 2.4 million shares of the inside selling security holders for one year whereas Bear Stearns knew and understood that those shares were to be sold immediately upon the initial public offering.

As the Second Circuit recognized,

> "Knowing participation in a fraudulent scheme may render a participant liable under § 10(b). See S.E.C. v. U.S. Envtl., Inc., 155 F.3d 107, 111 (2d Cir. 1998) cert. denied sub nom. Romano v. S.E.C., 119 S.Ct. 1755 (1999)." (Appendix p. 12a)

The associate managing director admitted to reading the first two sentences in that one paragraph. "Not recalling" to have read the third sentence of that one paragraph in these circumstances would be laughed out of court if this case had been before a federal court. Yet, that is precisely what managing director Keith Brigley admitted.

Virtually every circuit has held that knowledge of the facts contained in a document in one's hand should be imputed to that person or entity in circumstances far less

likely to have given such person actual knowledge than here where there was only one relevant paragraph upon which at least three senior officers focused. See e.g. Dodds v. Cigna Securities, Inc., 12 F.3d 346, 351 (2d Cir. 1993) cert. den. 511 U.S. 1019, 114 S.Ct. 1401, in which a woman with a 10th grade education who allegedly did not understand a prospectus was held not to be excused because "the means of knowledge are the same thing in effect as knowledge itself." Zobrist v. Coal-X, Inc., 708 F.2d 1511, 1518 (10th Cir. 1983); DeBruyne v. Equitable Life Assurance Society of the United States, 920 F.2d 457, 466 n.18 (7th Cir. 1990); Koke v. Stifel, Nicolaus & Co., Inc., 620 F.2d 1340, 1344 (8th Cir. 1980); Myers v. Finkle, 950 F.2d 165, 167 (4th Cir. 1991). While those cases involved inexperienced claimants, that is no reason not to apply it to more knowledgeable insiders who are experienced in Wall Street matters. As the 7th Circuit held in S.E.C. v. Jakubowski, 150 F.3d 675, 681, 682 (7th Cir. 1998), in upholding summary judgment against the defendant:

> "Over and over again, we say that people claiming to be *victims* of securities fraud may not claim to rely on oral statements inconsistent with written documents (even tedious prospectuses) available to them... That is no less true when the person claiming ignorance of the writing made rather than received misstatements...."

Indeed, it is most perverse to apply the rule of imputed knowledge to some inexperienced, uneducated person and yet not to apply it to people, such as those at Bear Stearns, who were no mere clerks, but a lawyer and senior management. Yet, arbitrators, under the ruling of this case, are allowed to make such a perverse ruling.

Thus, applying this vague standard of "manifest disregard", the Second Circuit held, without citation or reasoning:

> "[I]t is by no means clear that the doctrine of imputed knowledge applies in this context." (Appendix p. 12a)

This Court should grant review to determine whether there should be applicable standards to vacate such an apparently irrational arbitration decision.

A similar indulgence was made with respect to the arbitrators' discretion as to the false confirmations. The confirmations sent failed to disclose either that the sales to petitioner were on an underwriting or the fact that a 400% profit had been made. Rather, the confirmations represented that a market-making transaction had taken place. Not disclosing critical facts in a confirmation such as the existence of an underwriting or excessive profit, here 400%, has been consistently held violative of Rule 10(b). Chasins v. Smith Barney & Co., Inc., 438 F.2d 1167 (2d Cir. 1970); Ettinger v. Merrill Lynch Pierce Finner and Smith, 835 F.2d 1031, 1036 (3d Cir. 1987); Grandon v. Merrill Lynch Pierce Finner and Smith, 147 F.3d 184, 189, 190 (2d Cir. 1998), holding:

> "There exists an implied representation that broker-dealers charge their customers securities prices that are reasonably related to the prices charged in an open and competitive market....A broker-dealer commits fraud (in violation of § 10(b) and Rule 10b-5) by charging customers excessive markups without proper disclosure."

Yet, the Second Circuit concluded that:

> "But the arbitrators could have concluded that the language was not actually false, since Sterling Foster, in fact, was a market maker in ML Direct securities at the time, although not for all transactions." (Appendix p. 13a)

In other words because Sterling Foster sometimes makes a market in that security, it is okay not to disclose the underwriting because those other transactions did not involve an underwriting. This excuse surely stretches the law beyond the breaking point.

As to the 400% profit, the court allowed the arbitrators to find that Bear Stearns was "unaware of an introducing broker's undisclosed and excessive profit" (Appendix p. 13a). But the undisputed facts are that one of Bear Stearns' managing directors was aware that Sterling Foster had sold shares with closing prices at $15.25 and $15.50, and that same managing director had received shares from the inside selling shareholders with directions to pay these inside selling shareholders certain fixed amounts. Simple arithmetic dividing the number of shares received into the amount paid would easily disclose the 400% profit (e.g. Special Equities delivered 1,000,080 shares with instructions to pay Special Equities $3,510,000, a little over $3 a share). Yet, the arbitrators were allowed to find that Bear Stearns was "unaware" and the Second Circuit did not discuss imputed knowledge requirements.

With respect to the Securities Act of 1933, there can be no dispute that 15 U.S.C. Section 77e(b)(1) and CFR § 230.174(d) make it unlawful to send a confirmation within the first 25 days of an underwriting without sending the

prospectus. Loss & Seligman, Fundamentals of Securities Regulation 3 Ed., p. 94 "[A] full prospectus must precede or accompany delivery [of securities] or confirmation, whichever first occurs...." Thus, sending a confirmation when Bear Stearns admittedly knew that there was an underwriting without sending a prospectus violated the basic rule of law of the Securities Act of 1933.

Section 12(a)(1) of the 1933 Securities Act, 15 U.S.C. Section 77l(a)(1) provides the remedy for such violation - rescission. The Second Circuit said with respect to this:

> [N]othing in the [clearing] agreement between Bear Stearns and Sterling Foster unambiguously shifted the burden of complying with this requirement onto Bear Stearns." (Appendix p. 13a)

One must ask, since Bear Stearns clearly had the obligation to send confirmations for Sterling Foster's trades, who was supposed to send the prospectus, if not Bear Stearns? Most importantly, if Bear Stearns felt that it was not required to send the prospectus, it had no right to knowingly send out illegal confirmations for those trades and blithely assume that some other person perhaps is sending out the prospectus. There was no evidence that Bear Stearns even asked who was sending out the prospectus for the underwriting when it should have known, as a matter of absolute, basic securities law, that for Bear Stearns to send confirmations without that prospectus was a violation of the Securities Act of 1933.

It is submitted that the arbitrators in effect allowed Bear Stearns to violate the Securities Acts of 1933 and 1934 with impunity. These blatant violations have been sanctioned by the courts as not being in manifest disregard of the law.

Under this standard, as applied, it is clear that the petitioner was not given the basic protections to which he was entitled under the securities acts.

The securities industry is one of the most important in the United States. Confidence in the securities industry is essential. To maintain such confidence, it is necessary to impose liability for violation of the laws governing the securities industry. See: Black, *The Core Institutions that Support Strong Securities Markets*, 55 Business Lawyer 1565, 1568, August, 2000. Today, most customer disputes must be handled in arbitration because of the virtually universal use of the pre-dispute agreement with all customers. Thus, it is necessary to maintain the effectiveness of the securities laws through arbitration.

As previously noted, the NASD certainly cannot be perceived as an unbiased forum because so many of its arbitrators continually sit and make their living off of arbitration and may not want to give decisions that might alienate brokerages, which may subject them to being peremptorily challenged in future cases. That the facts in this case raise serious questions of public concern is demonstrated by the numerous newspaper reports regarding this matter. See e.g. Gretchen Morgenson, Testimony Implicates Bear Stearns, N.Y. Times, Jan. 30, 1999, at B 1; Gary Weiss, Did Bear Stearns Ignore A Stock Swindle, Business Week, Nov. 23, 1998, at 162. And Mr. Michael Harrington, who, at the time of these events, was in charge of the Bear Stearns Clearing Division, has since been forced to resign from Bear Stearns over a matter not related to the Sterling Foster fraud and has been barred by the SEC from the securities industry.

Thus, if charges of fraud in violation of the securities acts are to be handled through industry appointed panels,

pursuant to pre-arbitration agreements, then this Court must determine a method for the courts to review arbitrations so that the basic rights under the securities laws are in fact protected.

CONCLUSION

This Court should, therefore, grant the writ of certiorari to determine the standards under which public customers of securities firms can receive the protections to which they are entitled under the securities acts.

Dated: New York, New York
October 25, 2000

Respectfully submitted,

MORLEY AND TRAGER

By:_____
Leslie Trager (LT-8995)
Attorneys for Petitioner
230 Park Avenue
New York, New York 10169
(212) 684-2210

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

[Filed August 7, 2000]

No. 99-9041

HOWARD GREENBERG,
Petitioner-Appellant,

v.

BEAR, STEARNS & CO.,
BEAR, STEARNS & CO., INC.,
and BEAR, STEARNS
SECURITIES CORP.,
Respondents-Appellees.

Before: OAKES, WALKER, and KEITH,* Circuit Judges.

Appeal from the judgment of the United States District Court for the Southern District of New York (John S. Martin, Jr., District Judge), denying the motion by the petitioner-appellant to vacate an arbitration award.

* The Honorable Damon J. Keith of the United States Court of Appeals for the Sixth Circuit, sitting by designation.

Affirmed.

OPINION

JOHN M. WALKER, JR., Circuit Judge:

Petitioner-appellant Howard Greenberg appeals from the August 25, 1999 judgment of the United States District Court for the Southern District of New York (John S. Martin, Jr., District Judge), denying his petition to vacate an arbitration award that dismissed his securities fraud claims against respondents-appellees Bear, Stearns & Co., Inc., and Bear, Stearns Securities Corp. (collectively, "Bear Stearns"). On appeal, Greenberg argues that the district court's judgment should be reversed and the arbitration award against him vacated because the arbitrators manifestly disregarded federal law in rendering the award. Bear Stearns responds that there was no basis for federal subject matter jurisdiction in this case and that, in any event, the arbitral award easily withstands review.

This appeal squarely presents the question of whether and under what circumstances federal courts have jurisdiction to hear motions to vacate arbitration awards. We conclude that the district court had jurisdiction in this case because Greenberg challenged the award primarily on the grounds of manifest disregard of federal law. Nevertheless, Greenberg has not met the very stringent burden of demonstrating the sort of manifest disregard required to vacate the award. Therefore, we affirm the judgment of the district court.

BACKGROUND

At the time of the events underlying Greenberg's claim, Bear Stearns (a "clearing broker") provided securities clearing services to Greenberg's primary broker, Sterling Foster (an "introducing broker"). According to Greenberg, Bear Stearns violated federal and state securities laws because it knew of and participated in a fraudulent scheme perpetrated by Sterling Foster; sent false and misleading confirmations in connection with this scheme; and failed to send out a required prospectus. We briefly discuss the facts and allegations pertinent to the appeal.

In 1996, Sterling Foster organized the initial public offering ("IPO") for a company called ML Direct. Under an agreement between Bear Stearns and Sterling Foster, the latter requested permission from the former to underwrite this sale. According to Sterling Foster's plan, ML Direct would make a public sale of 1.1 million shares, and Sterling Foster would sell short an additional 2.3 million shares, to be covered by shares it would obtain from existing shareholders. This scheme was fraudulent, alleged the plaintiff, because the prospectus distributed to purchasers of ML Direct stock stated that shares from the selling shareholders were subject to a lock-up agreement for 12 months and that there were "no agreements or understandings . . . with respect to release of the securities prior to [this time]." Bear Stearns employees admitted having seen the prospectus, but did not recall reading the sentences about the lock-up. Bear Stearns agreed to clear the transaction.

In September 1996, the IPO and stock sales proceeded as planned. Sterling Foster allegedly reaped an enormous

profit at the expense of the selling shareholders by selling shares short and purchasing shares from those shareholders at a significantly lower price. Bear Stearns sent out confirmations to purchasers of ML Direct stock that stated: "Your broker makes a market in this security and acted as principal." The confirmations did not disclose Sterling Foster's short sales or its large profit, nor was a prospectus sent to those who purchased shares.

In May 1997, the petitioner filed a claim with the National Association of Security Dealers ("NASD") against Bear Stearns alleging, among other things, fraud and market manipulation in connection with Bear Stearns's provision of securities clearing services to Sterling Foster. A panel of three arbitrators heard arguments and testimony through extensive briefing and seven days of hearings. The arbitrators first dismissed Greenberg's claim based on Bear Stearns's purported failure to send him a prospectus and thereafter dismissed his remaining claims. On March 9, 1999, the arbitrators issued a written award confirming their decision to dismiss.

On January 18, 1999, Greenberg moved in federal district court to vacate the award on the basis that it "violated public policy and manifestly disregarded the law." In an opinion and award dated August 23, 1999, the district court denied the motion on the grounds that the petitioner had failed to demonstrate manifest disregard of the law in the arbitrators' treatment of his claims. This appeal followed.

DISCUSSION

I. Federal Jurisdiction

The principal question presented in this appeal is whether the district court had federal question jurisdiction over Greenberg's motion to vacate the arbitration award. Jurisdiction would plainly lie if, among other things, the parties were diverse, see 28 U.S.C. § 1332, the claim arose in admiralty, see 28 U.S.C. § 1333, or the dispute concerned the interpretation of a collective bargaining agreement, see 29 U.S.C. § 185(a). Cf. Drexel Burnham Lambert, Inc. v. Valenzuela Bock, 696 F. Supp. 957, 964-65 (S.D.N.Y. 1988) (Leval, J.) (listing some circumstances under which federal courts plainly have jurisdiction to hear a petition to compel arbitration). However, we must decide whether and under what circumstances a federal court may entertain a motion to vacate an award where, as in this case, alternative bases for jurisdiction are absent. We conclude that: (1) the fact that the arbitration itself concerns issues of federal law does not, on its own, confer subject matter jurisdiction on a federal district court to review the award; but (2) federal jurisdiction may lie where the petitioner seeks to vacate the award primarily on the ground of manifest disregard of federal law.

Federal courts have jurisdiction over "all civil actions arising under the . . . laws . . . of the United States." 28 U.S.C. § 1331. Federal question jurisdiction exists where a well-pleaded complaint "establishes either that federal law creates the cause of action or that the plaintiff's right to relief necessarily depends on resolution of a substantial question of federal law." Franchise Tax Bd. v. Construction Laborers Vacation Trust, 463 U.S. 1, 27-28 (1983).

Federal law plainly does not create the cause of action in this case. Greenberg filed his petition under § 10 of the Federal Arbitration Act ("FAA"), which authorizes "the United States court in and for the district wherein the [arbitration] award was made" to "make an order vacating the award" under certain circumstances. 9 U.S.C. § 10(a). However, it is well-settled that the FAA does not confer subject matter jurisdiction on the federal courts even though it creates federal substantive law. See Southland Corp. v. Keating, 465 U.S. 1, 16 n.9 (1984); Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 25 n.32 (1983). Therefore, federal question jurisdiction does not arise simply because a petitioner brings a claim under § 10 of the FAA; there must be "an independent basis of jurisdiction" before district courts may entertain petitions to vacate. Harry Hoffman Printing, Inc. v. Graphic Communications, Int'l Union, Local 261, 912 F.2d 608, 611 (2d Cir. 1990).

Simply raising federal-law claims in the underlying arbitration is insufficient to supply this "independent basis." In the context of a motion to compel arbitration under § 4 of the FAA, see 9 U.S.C. § 4, we have specifically held that there is no federal subject matter jurisdiction "merely because the underlying claim raises a federal question." Westmoreland Capital Corp. v. Findlay, 100 F.3d 263, 268 (2d Cir. 1996). Petitions to compel arbitration "must be brought in state court unless some other basis for federal jurisdiction exists, such as diversity of citizenship or assertion of a claim in admiralty." Id. Language in § 4 seemingly authorizing the federal courts to hear such petitions "is not intended to confer jurisdiction, but should instead be read as a response to the antiquated common law principle that an agreement to arbitrate would oust the federal courts of

jurisdiction." Id. at 267-68 (citing Valenzuela Bock, 696 F. Supp. at 961-62).

The holding in Westmoreland logically extends to motions to vacate an arbitration award under § 10 of FAA. Indeed, we implied as much in Westmoreland itself, see 100 F.3d at 268, and other courts have explicitly so held, see, e.g., Kasap v. Folger Nolan Fleming & Douglas, Inc., 166 F.3d 1243, 1247 (D.C. Cir. 1999); Ford v. Hamilton Invests., Inc., 29 F.3d 255, 257-58 (6th Cir. 1994); Lipton v. Shearson, 934 F. Supp. 638, 639 (S.D.N.Y. 1996); Magninelli v. Smith Barney, Inc., No. 98 Civ. 8986, 1999 WL 615096, at *1 (S.D.N.Y. Aug. 12, 1999). As with a motion under § 4, the only federal rights that a motion under § 10 necessarily implicates are those created by the FAA itself, which rights do not give rise to federal question jurisdiction. In both contexts, there is no necessary link between the requested relief and the character of the underlying dispute. For example, a petition to compel arbitration because the dispute falls within the scope of an arbitration clause, or to vacate an award because the arbitrators exceeded their powers under that clause, will turn on the interpretation of the clause, regardless of whether the actual dispute implicates any federal laws. Accordingly, the fact that the arbitration concerns issues of federal law does not, standing alone, confer subject matter jurisdiction on a federal district court to review the arbitral award.

Nevertheless, federal jurisdiction may still lie if the ultimate disposition of the matter by the federal court "necessarily depends on resolution of a substantial question of federal law." Barbara v. New York Stock Exch., Inc., 99 F.3d 49, 54 (2d Cir. 1996) (internal quotation marks omitted).

Thus we must decide whether the petition in this case to vacate an arbitral award presents a substantial question of federal law.

"[I]n determining federal question jurisdiction, courts must make principled, pragmatic distinctions, engaging in a selective process which picks the substantial causes out of the web and lays the other ones aside." Id. (internal quotation marks omitted). "[E]xamining only those allegations which are properly raised in a well-pleaded complaint, we look to the nature of the federal question raised in the claim to see if it is sufficiently substantial to warrant federal jurisdiction." Greenblatt v. Delta Plumbing & Heating Corp., 68 F.3d 561, 570 (2d Cir. 1995) (internal quotation marks omitted). The greater the federal interest at stake, the more likely it is that federal jurisdiction will be found. See West 14th St. Commercial Corp. v. 5 West 14th Owners Corp., 815 F.2d 188, 193 (2d Cir. 1987) (citing Merrell Dow Pharmaceuticals, Inc. v. Thompson, 478 U.S. 804, 814 n.12 (1986)).

In our view, under these standards, whether or not a petition to vacate under § 10 raises a substantial federal question turns on the ground for the petitioner's challenge to the award. The FAA and federal case law supply various bases for review of an arbitral award. Section 10 itself lists several grounds, including fraud in procuring the award; corruption, partiality, or prejudicial misconduct on the part of the arbitrators; abuse of power; and failure to render "a mutual, final, and definite award." 9 U.S.C. § 10(a). Judicial interpretation has added additional grounds, such that awards may be vacated under limited circumstances where the arbitrators manifestly disregarded the law, see DiRussa v. Dean Witter Reynolds Inc., 121 F.3d 818, 821 (2d Cir.

1997), or where enforcement would violate a "well defined and dominant public policy," IBEW Local 97 v. Niagara Mohawk Power Corp., 143 F.3d 704, 717 (2d Cir. 1998) (internal quotation marks omitted).

We hold that where, as here, the petitioner complains principally and in good faith that the award was rendered in manifest disregard of federal law, a substantial federal question is presented and the federal courts have jurisdiction to entertain the petition. In contrast to grounds of review that concern the arbitration process itself -- such as corruption or abuse of power -- review for manifest disregard of federal law necessarily requires the reviewing court to do two things: first, determine what the federal law is, and second, determine whether the arbitrator's decision manifestly disregarded that law. This process so immerses the federal court in questions of federal law and their proper application that federal question subject matter jurisdiction is present.

Where the arbitrators' alleged manifest disregard of federal law forms a key part of the petitioner's complaint about the award, the federal questions thereby presented are substantial enough to support federal jurisdiction. First, although review for manifest disregard is "severely limited," DiRussa, 121 F.3d at 821, if engaging in such review is essentially all that is required of the reviewing court, it is plain that federal questions will predominate. Second, there is a clear federal interest in resolving these questions. While federal claims may appropriately be resolved through arbitration, the federal courts have a strong interest in ensuring that arbitrators interpret and apply federal law properly, even if within a wide range of tolerance. Cf. Shearson/Am. Express Inc. v. McMahon, 482 U.S. 220, 232

(1987) ("[A]lthough judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute."). Indeed, as Judge Leval observed, this interest "would seem to be far greater" than the federal interest implicated by a petition to compel arbitration under § 4 -- that is, the "interest in seeing that the claims be arbitrated" in the first place. Valenzuela Bock, 696 F. Supp. at 963.

We note that, by and large, the rulings of other courts are not inconsistent. Many courts have found the simple presence of federal claims in the arbitration itself insufficient as an independent basis for federal jurisdiction. These cases, however, generally did not involve a petition to vacate on the grounds of manifest disregard of federal law in the arbitrators' resolution of the underlying federal claims. But see Manginelli, 1999 WL 615096, at *2 (holding that the "limited application and interpretation of federal law" required to rule on a petition to vacate an award on the grounds of manifest disregard is insufficient to "provide an independent basis for federal jurisdiction"). Instead, the petitioners challenged arbitration awards on grounds that plainly did not require resolution of a uniquely federal issue, including perjury, see Kasap, 166 F.3d at 1245; "alleged misdeeds of the arbitrators," Baltin v. Alaron Trading Corp., 128 F.3d 1466, 1472 (11th Cir. 1997); "fraud, corruption, undue means, evident partiality, and failure to consider pertinent and material evidence," Minor v. Prudential Sec., Inc., 94 F.3d 1103, 1105-06 (7th Cir. 1996); and manifest disregard of state law, see Ford, 29 F.3d at 258; Lipton, 934 F. Supp. at 639. The Seventh Circuit acknowledged that the federal courts might have jurisdiction if the motion to vacate involved, on its face, "the resolution of [the petitioner's] federal claims or

some question of federal law." Minor, 94 F.3d at 1106. But see Kasap, 166 F.3d at 1247 (suggesting that review for fraud under § 10 implicates federal law but that this is insufficient to support federal jurisdiction). Where the petitioner seeks vacatur chiefly on the ground of manifest disregard of federal law, a federal question is plainly presented.

In this case, if it were not for the claim that vacatur is warranted because federal law was manifestly disregarded, we would find no jurisdiction. The simple fact that the underlying arbitration implicated federal questions would not be enough. But because the petition alleges primarily that the award was rendered in manifest disregard of the federal laws underpinning these claims, federal question jurisdiction is present.

Accordingly, the district court had jurisdiction to consider Greenberg's petition, and this appeal is properly before us. We turn now to the merits.

II. Review of the Award for Manifest Disregard of the Law

The district court held that the petitioner had failed to demonstrate that the arbitral award was rendered in manifest disregard of the law. Review for manifest disregard is "severely limited." DiRussa, 121 F.3d at 821. In order to vacate an award on these grounds, a reviewing court must find "both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit, and clearly applicable to the case." Id. (internal quotation marks and alterations omitted). The party seeking

vacatur of the award bears the burden of showing manifest disregard under these standards. See Willemijn Houdstermaatschappij, BV v. Standard Microsystems Corp., 103 F.3d 9, 12 (2d Cir. 1997). A district court's application of the manifest disregard standard is a legal determination that we review de novo. See id.

The petitioner has failed to meet this very stringent burden with respect to any of his claims against Bear Stearns. First, Greenberg argues that the arbitrators manifestly disregarded federal law in denying his claim that Bear Stearns knew about Sterling Foster's fraudulent scheme and is therefore liable under § 10(b) of the Securities Exchange Act. Knowing participation in a fraudulent scheme may render a participant liable under § 10(b). See S.E.C. v. United States Envtl., Inc., 155 F.3d 107, 111 (2d Cir. 1998), cert. denied sub nom. Romano v. S.E.C., 119 S. Ct. 1755 (1999). In this case, however, Bear Stearns employees testified that they did not know about Sterling Foster's fraud, and thus the arbitrators could reasonably have concluded that Bear Stearns lacked the knowledge required for § 10(b) liability. The petitioner argues that Bear Stearns should be deemed to have knowledge of the fraud because it had the necessary information before it, but it is by no means clear that the doctrine of imputed knowledge applies in this context.

Second, according to Greenberg, Bear Stearns violated federal securities law by sending knowingly false confirmations. The confirmations were allegedly misleading because, while they made certain disclosures, they failed to reveal that the transaction was an underwriting, not a market sale, and that Sterling Foster was reaping a 400% profit from the scheme. But the arbitrators could have concluded that the

language was not actually false, since Sterling Foster, in fact, was a market maker in ML Direct securities at the time, although not for all transactions. In addition, there is no well-settled law imposing a duty upon a clearing broker, who is unaware of an introducing broker's undisclosed and excessive profit, to inquire into the matter and then inform the latter's customers of such self-dealing.

Third, Greenberg contends that Bear Stearns failed to comply with 17 C.F.R. § 230.174, which requires delivery of a prospectus in connection with the sale of newly issued securities. But the regulation imposes this requirement only on underwriters and dealers, not on clearing brokers, and nothing in the agreement between Bear Stearns and Sterling Foster unambiguously shifted the burden of complying with this requirement onto Bear Stearns.

Finally, Greenberg asserts that Bear Stearns should be held liable as an aider and abetter under New York law because it participated in the fraudulent scheme and provided substantial assistance to Sterling Foster. See S & K Sales Co. v. Nike, Inc., 816 F.2d 843, 847-48 (2d Cir. 1987). However, there was ample basis for the arbitrators to conclude that Bear Stearns's participation was insufficient to constitute substantial assistance. "[T]he simple providing of normal clearing services to a primary broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker." Stander v. Financial Clearing & Servs. Corp., 730 F. Supp. 1282, 1286 (S.D.N.Y. 1990); cf. Edwards & Hanly v. Wells Fargo Sec. Clearance Corp., 602 F.2d 478, 484 (2d Cir. 1979) (clearing brokers owe no separate duty to customers of an introducing broker).

In sum, the arbitrators did not ignore or refuse to apply well-defined and clearly applicable law in rejecting any of the appellant's claims in such a way that would amount to manifest disregard.

CONCLUSION

For the foregoing reasons, we hold that: (1) where, as here, a § 10 petitioner complains principally and in good faith that an arbitration award was rendered in manifest disregard of federal law, the federal courts have jurisdiction to entertain the petition; and (2) the district court in this case properly rejected the petitioner's claim for failure to demonstrate that the arbitrators had manifestly disregarded the law in their treatment of his securities claims. We have considered the petitioner's other arguments and find them to be without merit. Accordingly, we affirm the judgment of the district court.

APPENDIX B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

[Dated August 23, 1999]

No. 99 Civ. 358 (JSM)

HOWARD GREENBERG ,
Petitioner,

v.

BEAR STEARNS & CO., INC.
and BEAR STEARNS
SECURITIES CORP.,
Respondents.

MEMORANDUM OPINION AND ORDER

JOHN S. MARTIN, Jr., District Judge:

This case is before the Court on a petition to vacate an arbitral award dismissing all of petitioner's claims.

Bear Stearns served as the clearing broker for Sterling Foster, a now-defunct brokerage house whose President, Adam Lieberman, pled guilty in this District to securities fraud charges. One of the fraud schemes Sterling Foster carried out involved the fraudulent sale of shares of ML

Direct, a company whose stock offering Sterling Foster underwrote. Sterling Foster sold shares of ML Direct short and then released into the market ML Direct shares that were supposed to be "locked up." The flood of ML Direct shares on the market caused the share price to drop, and petitioner Howard Greenberg, who bought 29,000 shares in September 1996, lost the value of his investment.

An NASD arbitration panel heard petitioner's claim over seven days and dismissed all his claims at the end of the arbitration. Petitioner seeks to have the arbitral award overturned because it is in manifest disregard of the law. Wilko v. Swan, 346 U.S. 427, 436-437, 74 S.Ct. 182, 187 (1953) rev'd on other grounds Rodriguez de Quijas v. Shearson/American Express Inc., 490 U.S. 477, 109 S.Ct. 1917 (1989); Carte Blanche (Singapore) Pte., Ltd. v. Carte Blanche Int'l, Ltd., 888 F.2d 260, 265 (2d Cir. 1989).

Review of an arbitral decision for manifest disregard of the law is "severely limited." DiRussa v. Dean Witter Reynolds Inc., 121 F.3d 818, 821 (2d Cir. 1997) (citations omitted). To modify or vacate an award, a court must find both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law ignored by the arbitrators was well defined, explicit and clearly applicable to the case. Id. (citations and quotations omitted). A court may also modify or vacate an award if there is "strong evidence" contrary to the findings of the panel and the panel has not provided an explanation of its decision. Halligan v. Piper Jafray Inc., 148 F.3d 197, 204 (2d Cir. 1998).

Petitioner first claims that the arbitrators incorrectly denied his claims that Bear Stearns knew, as a matter of fact and law, of the premature sale of restricted ML Direct securities. The panel heard testimony from the three Bear Stearns employees who possessed sections of the ML Direct prospectus prior to the sales in question. Each testified that they did not know that certain ML Direct shares were subject to a lock-up provision. The arbitrators credited the testimony of these employees and rejected Greenberg's contention that Bear Stearns knew but ignored the premature sale of restricted securities. The Court will not second-guess the credibility findings of the arbitral panel and will not disturb the panel's findings that Bear Stearns lacked knowledge of Sterling Foster's fraud scheme.

Petitioner's legal argument rests upon cases that impose a "duty to read" upon parties to a contract. Dodds v. Cigna Securities, 12 F.3d 346, 351 (2d. Cir. 1993); see Wood v. Carpenter, 101 U.S. 135, 143 (1879) ("The means of knowledge are the same thing as knowledge itself."). While it is true that in some circumstances the law will preclude a party from asserting that he was unaware of the terms of a contract he signed or a document he read, there is no general rule that one who may once have had possession of a document can not thereafter deny knowledge of something contained therein. The concept of imputed knowledge seeking to avoid the obligation of a contract by denying knowledge of its terms at the time it was signed, or situations where a party asserting a claim of fraud denies knowledge facts set forth in a document that he was given to review in the course of the transaction at issue. The "duty to read" cases did not require the arbitrators to find that the parties engaged in fraudulent conduct by applying an irrebuttable presumption that a party

must have known a fact contained in a document he once possessed. Accordingly, the proposition that Bear Stearns knew, as a matter of law, that Sterling Foster was engaged in fraud is not a governing legal principle that the panel failed to apply. Halligan, 148 F.3d at 202.

Petitioner's second contention is that Bear Stearns participated in the Sterling Foster fraud scheme through its underwriting work. Petitioner submitted the following evidence to support his claim of collusion between Bear Stearns and Sterling Foster: Richard Harriton, a high ranking Bear Stearns official, personally granted Sterling Foster permission to clear its sales of ML Direct securities through Bear Stearns; Harriton required Sterling Foster to deposit $3 million with Bear Stearns to cover its trades and required Sterling Foster's chairman Adam Lieberman to assume personal liability for any money owed Bear Stearns as a result of clearing activities; Bear Stearns employees expressed concern amongst themselves regarding their credit exposure in clearing ML Direct shares and Bear Stearns made a profit on clearing the trades.

The arbitrator's decision that this evidence is insufficient to establish Bear Stearns' complicity in the Sterling Foster scheme does not reflect a manifest disregard of the evidence or the law.

First, clearing brokers do not owe a separate duty to the customers of an introducing broker. Edwards and Hanly v. Wells Fargo Securities, 602 F.2d 478, 484 (2d Cir. 1979); Dillon v. Militano, 731 F.Supp. 634, 636 (S.D.N.Y. 1990). Petitioner's recourse for Sterling Foster's fraud lies with Sterling Foster, not the clearing house.

Second, the arbitrators heard evidence that the conduct complained of is within the normal course of business for a clearing house when clearing transactions for an underwriting introducing broker. The evidence presented to the arbitrators is not so biased as to allow the Court to vacate the arbitrator's own assessment of this evidence.

Lastly, the conduct described to the arbitrators was not fraudulent. See Ross v. Bolton, 1989 WL 80428 aff'd 904 F.2d 819, 824 (2d Cir. 1990).

Petitioner also asserted to the panel that Bear Stearns knowingly participated in Sterling Foster's breach of fiduciary duties in violation of New York law. See S & K Sales v. Nike Inc., 816 F.2d 843, 847-848 (2d Cir. 1987). As discussed above, the panel apparently declined to credit petitioner's contention that Bear Stearns knew of the Sterling Foster fraud. The panel's obvious conclusion that Bear Stearns employees did not have scienter as to the 10(b) claims also negates petitioner's state law claim of knowing collusion.

Petitioner also complains that the arbitrators neglected the law and evidence regarding Bear Stearns's obligation to send prospectuses in accordance with Rule 174 of the Securities Act of 1933. Petitioner cannot contest that 17 C.F.R. § 230.174 imposes upon a dealer or underwriter the obligation to send a prospectus under certain circumstances. Bear Stearns is not liable for any failure to send a prospectus to petitioner absent evidence that Bear Stearns assumed responsibility for this underwriting function. The arbitrators reviewed the agreement between Bear Stearns and Sterling Foster and found insufficient evidence to impose this obligation upon Bear Stearns. Petitioner has failed to

establish that this decision was in violation of law or against the weight of the evidence presented to the panel. Rather, petitioner asks the Court to review the panel's legal findings de novo and to substitute its interpretation of the evidence for that of the panel. Such review, however, would be beyond the scope of review of an arbitral decision.

Lastly, petitioner objects to the panel's finding that the legend Bear Stearns printed on trade confirmation tickets was neither false, misleading nor in violation of SEC Rule 10b-10. see 17 C.F.R. § 240.10b-10(a) (2).

The trade confirmation tickets petitioner received stated "Your broker makes a [market] in this security, and acted as principal." See Pet. Exh. L. Petitioner first claims that the legend is misleading because it implies that he purchased ML Direct securities in a market transaction and not from an underwriter. While this may be a reasonable inference, the panel apparently decided that the legend was not misleading because it was true. The fact that an introducing broker makes a market in a given security does not lead to the sole conclusion that every transaction with that broker is a market transaction.

Petitioner's second point concerning trade confirmations concerns the 400% profit Sterling Foster made on fraudulent sales of ML Direct stock. Petitioner relies on S.E.C. v. First Jersey Securities, 101 F.3d 1450, 1472 (2d Cir. 1996) to suggest that Bear Stearns owed him a duty to inform him of Sterling Foster's outrageous profit. This argument is without merit because the defendant in First Jersey was a broker-dealer that manipulated customers by misleading its own sales force. The legal duty of a broker-

dealer to notify purchasers of its own self dealing cannot be imposed upon Bear Stearns, a clearing broker that the panel found was unaware of Sterling Foster's fraud.

For the foregoing reasons the petition to overturn the arbitral award is denied. The Clerk of Court is instructed to close this case.

SO ORDERED.

Dated: New York, New York
August 23, 1999

/s/_____
JOHN S. MARTIN, JR., U.S.D.J.

(2)

No. 00-699

Supreme Court, U.S.
FILED
DEC 4 - 2000

IN THE
Supreme Court of the United States
OCTOBER TERM, 2000

HOWARD GREENBERG,

Petitioner,

v.

BEAR, STEARNS & CO., BEAR, STEARNS & CO., INC. AND BEAR, STEARNS SECURITIES CORP.,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF IN OPPOSITION TO PETITION

JACK P. LEVIN
Counsel of Record
P. BENJAMIN DUKE
COVINGTON & BURLING
1330 Avenue of the Americas
New York, NY 10019
(212) 841-1000

Attorney for Respondents Bear, Stearns & Co., Inc. and Bear, Stearns Securities Corp.

December 2000

QUESTIONS PRESENTED

1. Should arbitral awards deciding claims under the federal securities laws be subject to a heightened standard of review not applicable to awards involving other statutory claims?

2. Did the Court of Appeals err in concluding that the arbitral award in this case, which was rendered by a three-member arbitration panel based on extensive witness testimony and other evidence, did not constitute a "manifest disregard of the law"?

PARTIES TO THE PROCEEDING AND STATEMENT PURSUANT TO RULE 29.6

Respondents Bear, Stearns & Co., Inc. and Bear, Stearns Securities Corp. are wholly-owned subsidiaries of The Bear, Stearns Companies Inc. Contrary to the captioned listing of parties in this case, there is no separate entity incorporated as "Bear, Stearns & Co."

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BRIEF IN OPPOSITION TO PETITION

INTRODUCTION

This Petition is Petitioner Howard Greenberg's third attempt to overturn the award (the "Award") of a National Association of Securities Dealers ("NASD") arbitration panel dismissing his claims after a full evidentiary hearing. Petitioner's principal contention is that "there should be applicable standards to vacate . . . an apparently irrational arbitration decision" under the Federal Arbitration Act (the "FAA"). Pet. at 16. In reality, such a standard already exists, and the Second Circuit properly applied it in affirming the district court's denial of Greenberg's petition to vacate the Award. The Petition fails to identify any conflict among the federal circuits concerning the "manifest disregard of the law" standard applied below, nor does it suggest that any other circuit would have reached a different result had it reviewed this case. Though Petitioner decries the purported unfairness of arbitrations conducted by the securities industry's self-regulatory organizations ("SROs"), he points to no evidence that the manifest disregard standard provides an inadequate level of review. Moreover, the Petition simply ignores the recent decision of this Court in *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995), which cited that standard with approval.

Far from raising a compelling legal question for review, Petitioner asks this Court to revisit the factual record and rule anew upon fact-bound issues decided by the arbitrators. The decision below correctly concluded that the the Award was rooted in findings of fact and witness credibility that should not be disturbed. Petitioner's repeated assertions that the pertinent facts are "undisputed" and "simple," *see* Pet. at 5, 9, 13, 14, 17, and that the Award is "irrational" and "perverse," *see id.* at 13, 15, 16, are refuted

by the record and were properly rejected. Indeed, the Petition fails even to address several independent factual and legal grounds supporting the Award. In any event, Petitioner merely challenges the lower courts' straightforward application of an accepted standard of review and therefore does not raise any issue warranting this Court's attention.

Even if the Petition raised compelling questions for review, the Court could reach those questions only if it first agreed with the Second Circuit's threshold conclusion that it had subject matter jurisdiction over Greenberg's petition to vacate pursuant to § 10 of the FAA, 9 U.S.C. § 10. This potentially dispositive issue might preclude this Court's consideration of the questions presented by Petitioner and makes this Petition particularly inappropriate for review. For these reasons, Respondents respectfully submit that the Petition for Writ of Certiorari should be denied.

OPINIONS BELOW

The opinion of the Second Circuit is reported at 220 F.3d 22 (2d Cir. 2000). The opinion of the District Court does not appear in an official reporter, but is accessible on the Westlaw electronic database at 1999 WL 642859 (S.D.N.Y. Aug. 23, 1999).

STATEMENT OF THE CASE

The Petition's "Statement of the Case" contains a lengthy and grossly misleading account of the factual record developed in the underlying arbitration. While most of the pertinent facts are recited accurately in the Second Circuit's opinion, *see* 220 F.3d at 24-25, the Petition's numerous factual misstatements call for a corrective response here.

Greenberg's claims arose from alleged investment losses he suffered as a customer of non-party Sterling Foster & Co., Inc. ("Sterling Foster"), an independent retail broker-

dealer, in 1995 and 1996. During that period, respondent Bear, Stearns Securities Corp. ("Bear Stearns"), a wholly-owned subsidiary of co-respondent Bear, Stearns & Co., Inc., provided "back-office" securities clearance services to Sterling Foster pursuant to an arms-length contract approved by the New York Stock Exchange.

The arbitration hearing extended over seven days between September and November 1998. The central focus of the hearing was the events surrounding the initial public offering ("IPO") of ML Direct, Inc. ("ML Direct") in September 1996. Greenberg contended that the ML Direct IPO was fraudulent because, *inter alia*, the IPO prospectus falsely represented that the underwriter had no "present intention" to release, for sale in the public secondary market, 2.4 million ML Direct shares held by so-called "selling shareholders" which were subject to a 12-month "lock-up" agreement. At the hearing, Respondents took no position concerning whether Sterling Foster had committed fraud, but denied any knowledge of such fraud and maintained that Bear Stearns merely provided customary back-office services to Sterling Foster by clearing the ML Direct transactions.

Contrary to Greenberg's assertion, it was not "undisputed" at the hearing that anyone reading the ML Direct prospectus provided to Bear Stearns would have known "beyond per adventure of doubt [*sic*]," Pet. at 5, about Sterling Foster's intention to commit fraud. As the Petition acknowledges, *see id.* at 6, Bear Stearns obtained only a preliminary prospectus prior to the ML Direct offering and therefore did not know the contents of the final document. (A 102, 112)[1] In any event, all Bear Stearns witnesses testified that they did not read the technical language of the

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[1] References to the Joint Appendix filed in the court below are cited as "A ____."

preliminary prospectus concerning sale restrictions and had no knowledge of any arrangements to release a lock-up agreement prior to the specified period. (A 110, 112, 134-38. 373.)

The Petition also incorrectly implies that only 1.1 million ML Direct shares were "set forth in the prospectus," and that Bear Stearns improperly "distributed . . . three times that number or 3.5 million shares." Pet. at 8. In fact, the ML Direct prospectus covered the registration of 3.5 million shares, comprising 1.1 million IPO shares and a separate 2.4-million share "shelf registration." (A 66-69.) Moreover, Bear Stearns did not "distribute" shares; as a clearing firm, it processed transactions in ML Direct executed by Sterling Foster in its customers' accounts. There was no allegation that ML Direct shares were sold without being properly registered or that Bear Stearns itself acted as an underwriter with respect to those shares. Bear Stearns also introduced evidence that the ML Direct stock certificates delivered to it for deposit to Sterling Foster's account were freely tradable and in proper form.

The Petition further mischaracterizes as "undisputed" Greenberg's contention that the sale of the selling shareholders' shares was a risky "short sale" and an "underwriting of a most unusual sort." Pet. at 5. To the contrary, there was evidence that the ML Direct offering merely resulted in a technical deficit, or short "position," in Sterling Foster's proprietary accounts, which was then eliminated by the delivery of additional shares. (A 130.) Moreover, Bear Stearns typically received certificates for public offering shares *after* the shares had been sold to customers; as a result, temporary short positions in such circumstances were not abnormal, but routine. (A 486, 104, 130.) Throughout the hearing, Bear Stearns vigorously contested and introduced evidence contradicting Greenberg's version of these events.

Also misleading is the Petition's vague assertion that Bear Stearns "handled" payments by Sterling Foster to "insiders" and knew that Sterling Foster reaped "a 400% profit" on the sale of selling shareholders' shares. Pet. at 8. At the hearing, Greenberg contended that Bear Stearns must have learned about such illegal profits from memoranda it received from Sterling Foster referencing the receipt of ML Direct shares and requesting that Bear Stearns issue checks in specified amounts against a Sterling Foster proprietary account. (A 276-77.) Bear Stearns denied that anyone at Bear Stearns had attempted to compute Sterling Foster's purchase price for such shares, and no Bear Stearns witness testified to the contrary. There was testimony that such a computation would have been both irrelevant to Bear Stearns' clearing functions and meaningless, since Bear Stearns could not determine whether other consideration not mentioned in the memoranda had been paid for the shares. (A 285.) As a clearing firm, Bear Stearns issued the checks without inquiry, provided that Sterling Foster's accounts contained sufficient equity to cover the payments. (A 276-77.)

In sum, the Petition ignores the abundant evidence presented to the arbitrators that Bear Stearns' actions were consistent with the normal provision of clearance services to introducing brokers and did not bespeak knowledge of Sterling Foster's alleged misconduct.

REASONS FOR DENYING THE PETITION

I. The Manifest Disregard Standard Is Applied in Every Federal Circuit and Has Been Approved By This Court.

The Petition vaguely challenges the Second Circuit's use of the "manifest disregard" standard in reviewing the Award and implies that a conflict exists among the circuit courts concerning the standard's validity. *See* Pet. at 10.

There is no such conflict, and this Court has recently indicated its approval of review for "manifest disregard."

Since *Wilko v. Swan*, 346 U.S. 427 (1953), *overruled on other grounds*, *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989), federal courts have cited "manifest disregard of the law" as a basis for vacating an arbitral award, in addition to the statutory grounds set forth in FAA § 10(a). In *Wilko*, the Court contrasted an arbitrator's mere legal misinterpretation or error with "manifest disregard" and indicated that only the latter constituted a valid basis to overturn an award. *See* 346 U.S. at 435-37. Today, "each of the ... numbered circuits and the D.C. Circuit have recognized manifest disregard of the law as either an implicit or nonstatutory ground for vacatur under the FAA." *Williams v. Cigna Financial Advisors, Inc.*, 197 F.3d 752, 759 (5th Cir. 1999).[2]

While this Court has not directly considered the manifest disregard standard since first enunciating it in *Wilko*, the Court's unanimous decision in *First Options of Chicago, Inc. v. Kaplan*, *supra*, reiterates and implicitly approves that standard. *First Options* concerned, *inter alia*, the standard of review to be applied to arbitrators' decisions on whether the parties had submitted a particular matter to arbitration. In analyzing the practical significance of this

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[2] *See, e.g.*, *Montes v. Shearson Lehman Bros., Inc.*, 128 F.3d 1456 (11th Cir. 1997); *Barnes v. Logan*, 122 F.3d 820 (9th Cir. 1997), *cert. denied*, 523 U.S. 1059 (1998); *Cole v. Burns Int'l Sec. Servs.*, 105 F.3d 1465 (D.C. Cir. 1997); *M&C Corp. V. Erwin Behr GmbH & Co.*, 87 F.3d 844 (6th Cir. 1996); *United Transp. Union Local 1589 v. Suburban Transit Corp.*, 51 F.3d 376 (3d Cir. 1995); *Remmey v. PaineWebber, Inc.*, 32 F.3d 143 (4th Cir. 1994), *cert. denied*, 513 U.S. 1112 (1995); *Lee v. Chica*, 983 F.2d 883 (8th Cir.), *cert. denied*, 510 U.S. 906 (1993); *Health Servs. Mgmt. Corp. v. Hughes*, 975 F.2d 1253 (7th Cir. 1992); *Advest, Inc. v. McCarthy*, 914 F.2d 6 (1st Cir. 1990); *Jenkins v. Prudential-Bache Sec., Inc.*, 847 F.2d 631 (10th Cir. 1988).

issue, the Court summarized the standards of review applied by federal courts reviewing arbitral decisions on the merits:

> [A] party [that has been required to arbitrate] still can ask a court to review the arbitrator's decision, but the court will set that decision aside only in very unusual circumstances, See, e.g., 9 U.S.C. § 10 (award procured by corruption, fraud, or undue means; arbitrator exceeded his powers); *Wilko v. Swan*, 346 U.S. 427, 436-37, 74 S.Ct. 182, 187-188, 98 L.Ed. 168 (1953) (*parties bound by arbitrator's decision not in "manifest disregard" of the law*), overruled on other grounds, *Rodriguez de Quijas v. Shearson/ American Express, Inc.*, 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526 (1989).

Id. at 942 (emphasis added). Thus, the Court plainly recognized "manifest disregard" as a valid basis for vacatur of arbitral decisions under federal law and indicated that *Wilko*, insofar as it established that standard, remains good law.[3]

Greenberg's assertion that the Fifth Circuit "does not even recognize the vague concept of manifest disregard," Pet. at 10, is wrong. The case on which Greenberg relies, *Gulf Coast Funds Workers Union v. Exxon Co.*, 991 F.2d 244 (5th Cir. 1993), was expressly rejected in a later Fifth Circuit decision, which concluded that the above-quoted language in

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[3] *See also Shearson/American Express v. McMahon*, 482 U.S. 220 (1987) (Blackmun, J., concurring in part and dissenting in part) (judicial review of arbitral awards "substantially limited" to explicit grounds listed in FAA § 10 "and to the concept of 'manifest disregard' of the law"); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 656-57 (1985) (Stevens, J., dissenting) ("Arbitration awards are only reviewable for manifest disregard of the law[.]").

First Options compelled the lower courts to review arbitration awards for "manifest disregard of the law." *See Williams*, *supra*, 197 F.3d at 757-59. In *Williams*, the Fifth Circuit stated:

> In our opinion, clear approval of the "manifest disregard" of the law standard in the review of arbitration awards under the FAA was signaled by the Supreme Court's statement in *First Options* that "parties [are] bound by [an] arbitrator's decision not in 'manifest disregard' of the law."

Id. at 759 (quoting 514 U.S. at 942). At least two other circuits have construed *First Options* in the same manner. *See Montes v. Shearson Lehman Bros., Inc.*, 128 F.3d 1456, 1460 (11th Cir. 1997); *Cole v. Burns Int'l Sec. Servs.*, 105 F.3d 1465, 1486 (D.C. Cir. 1997).

Moreover, although circuits have adopted varying formulations of the review mandated by the manifest disregard doctrine, *see Cole*, 105 F.3d at 1486-87 & n.20 (giving examples), Greenberg makes no claim that the outcome of this case would have been different under the standard as applied in any circuit. Nor does he contend that any circuit applying the standard accords less deference to arbitral decisions than that given by the Second Circuit in the decision below. Indeed, the Fifth Circuit's refusal to apply manifest disregard in *Gulf Coast Funds*, *supra*, on which Greenberg relies, would have resulted in even narrower review of the Award than both lower courts conducted here. Thus, even if some disagreement about the manifest disregard standard existed among the circuits, this case would not be a proper vehicle for resolving such a conflict.

II. This Court Has Previously Rejected Any Special Standard of Review for Arbitral Decisions Under the Federal Securities Laws.

Greenberg also contends that, even if "manifest disregard" is nominally the proper standard, arbitral decisions concerning "the rights of investors under the Federal Securities Act" should be subject to "effective," *i.e.*, heightened, judicial review. Pet. at 13. In support of that contention, the Petition advances a generalized attack on the fairness of the securities industry arbitration system in disputes brought by individual investors. *See* Pet. at 10-13. These arguments, however, fly in the face of this Court's prior decisions affirming the legitimacy of securities arbitration. Greenberg fails to demonstrate any basis for the Court to revisit these issues again here.

In *Shearson/American Express v. McMahon*, 482 U.S. 220 (1987), this Court held that pre-dispute arbitration agreements are enforceable with respect to claims under § 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. § 78j. *McMahon* rejected the "general suspicion of the desirability of arbitration and the competence of arbitral tribunals" that had informed the Court's prior holding in *Wilko v. Swan*, *supra*, which held claims under § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2), to be non-arbitrable. *See McMahon*, 482 U.S. at 233. The *McMahon* Court expressly noted the "intervening changes" in securities industry arbitration procedures that had occurred since *Wilko*, including the 1975 Exchange Act amendments giving the Securities Exchange Commission "expansive power" to approve, "'abrogate, add to, and delete from' any SRO rule" to accord with the requirements of the Exchange Act. *Id.* (quoting 15 U.S.C. § 78s(c)). Thus, the Court concluded:

> In short, the Commission has broad authority to oversee and to regulate the rules adopted by

> the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.

Id. at 233-34. This reasoning was reaffirmed by the Court two years later in *Rodriguez de Quizas v. Shearson/American Express, Inc.*, *supra*, which explicitly overruled the holding of *Wilko* on non-arbitrability of § 12(2) claims. *See* 490 U.S. at 477.

In light of the Court's pronouncements in *McMahon* and *Rodriguez de Quizas*, Greenberg's general allegations of bias in the securities arbitration system at most raise policy matters that should be addressed to the SEC and the SROs, not this Court. The Petition cites no evidence that these regulatory authorities have not performed their duty to oversee this system in the public interest, consistent with the purpose of the federal securities laws. Indeed, the First Circuit recently rejected allegations of "structural bias" in the New York Stock Exchange ("NYSE") arbitration procedures, concluding that there was no evidence of bias in, *inter alia*, the organizational structure of the NYSE, the pool of potential NYSE arbitrators, or the procedures for selecting arbitration panels. *See Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 170 F.3d 1, 14-15 (1st Cir. 1999). In this case, the NASD procedures that governed the underlying arbitration proceedings were substantially the same as those specifically considered in *McMahon*. Greenberg fails to muster any credible basis for reconsidering the Court's previous approval of SRO-sponsored securities arbitration.

It bears mention that the Petition nowhere suggests the arbitrators in Greenberg's case were actually biased, failed to comply with the relevant NASD procedures, or acted improperly in any way during the arbitration. The panel that issued the Award was indisputably subject to the

system of oversight endorsed in *McMahon*. Had Greenberg believed he had suffered such prejudice, he could have sought to vacate the Award under FAA § 10(a)(2), which expressly provides for vacatur of an award where the arbitrators are guilty of "evident partiality or corruption" or prejudicial "misconduct" in conducting the arbitration proceedings. 9 U.S.C. § 10(a)(2). Greenberg never raised such a claim either in his initial petition to the district court or on further appeal to the Second Circuit. Nor does he attempt to do so here.

Finally, the Petition's appeal for a heightened standard of review in arbitrations involving federal securities claims is in direct conflict with "the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions," *Rodriguez de Quijas*, 490 U.S. at 484. This Court's consideration of a special standard in securities arbitrations would invite similar challenges in other statutory fields where the Court previously has upheld the broad federal policy favoring arbitration. *See, e.g., Mitsubishi Motors Corp., supra*, 473 U.S. at 628-40 (antitrust laws); *McMahon*, 482 U.S. at 240-42 (RICO statutes). As the Court stated in *First Options*: "[I]t is undesirable to make the law more complicated by proliferating review standards without good reasons." 514 U.S. at 948. The Petition offers no good reasons to do so here.

III. The Arbitration Award Was Based on Factual Findings to Which the Court Below Properly Deferred.

At bottom, Greenberg simply asks this Court to find – contrary to the judgment of both courts below – that the arbitrators' decision was "irrational." *See* Pet. at 16. This ordinary exercise of reviewing the Award for manifest disregard of the law does not warrant this Court's attention.

In any event, none of Greenberg's substantive challenges to the Award has any merit.

While the Petition contends that the arbitrators were "irrational" to conclude Bear Stearns had no knowledge of Sterling Foster's fraud, it flatly ignores other sufficient grounds for the rejection of Greenberg's claim under § 10(b) of the Exchange Act. As a clearing firm, Bear Stearns had no duty to disclose even material information to customers of Sterling Foster, including Greenberg. *See, e.g., In re Blech Securities Litigation*, 928 F. Supp. 1279, 1295-96 (S.D.N.Y. 1996) ("Even if Bear Stearns knew but failed to disclose a material fact, no plaintiff can claim to have been defrauded by that omission, because, as a matter of law, a clearing broker owed no duty of disclosure to the clients of an introducing broker."); *Ross v. Bolton*, 904 F.2d 819, 826 (2d Cir. 1990) (same). Moreover, Greenberg failed to demonstrate that Bear Stearns made any affirmative misrepresentation or engaged in any "manipulative or deceptive practice," as required to prove a claim under § 10(b), *see, e.g., SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996). Regardless of *scienter*, the arbitrators could have rejected Greenberg's § 10(b) claim on this wholly independent ground.

The Second Circuit's decision acknowledges this possible basis for the arbitrators' decision. The court concluded that the arbitrators had "ample basis" to find Bear Stearns' conduct insufficient to prove the "substantial assistance" element of a common-law aiding-and-abetting claim, much less the affirmative deception required by § 10(b). *See* 220 F.3d at 29. The Petition does not quarrel with the principle, cited by the Second Circuit, that "'the simple providing of normal clearing services to a primary broker who is acting in violation of the law does not make out a case of aiding and abetting against the clearing broker.'" *Id.* (quoting *Stander v. Financial Clearing & Servs. Corp.*, 730 F. Supp. 1282, 1286 (S.D.N.Y. 1990)).

Although Greenberg contended at the hearing that Bear Stearns had gone beyond "ordinary clearing" for Sterling Foster, this was a disputed factual issue that the arbitrators could have resolved in favor of Bear Stearns. The Petition does not contend otherwise.

Greenberg's insistence that the hearing testimony of certain Bear Stearns witnesses was not credible presented a pure question of fact for the arbitrators, and the decision below properly recognized it as such. *See* 220 F.3d at 28; *see also* 1999 WL 642859, at *1 (S.D.N.Y. Aug.23, 1999) ("The arbitrators credited the testimony of [Bear Stearns] employees and rejected Greenberg's contention .... The Court will not second-guess the credibility findings of the arbitral panel and will not disturb the panel's findings that Bear Stearns lacked knowledge of Sterling Foster's fraud scheme."). The Petition's mere assertion that certain testimony "would be laughed out of court if this case had been before a federal court," Pet. at 14, certainly does not make it so.

Greenberg's attempt to turn this fact-bound credibility dispute into a legal question of "imputed" knowledge also has no merit and was properly rejected. The Petition complains that the Second Circuit did not cite authorities for its conclusion that "'it is by no means clear that the doctrine of imputed knowledge applies in this context.'" Pet. at 5 (quoting 220 F.3d at 28). But the Petition simply ignores explicit case law (which Bear Stearns cited in its appellate brief) holding that knowledge of documents' contents should not be imputed to a financial entity performing high-volume processing functions like those performed by clearing firms. *See Woods v. Bank of New York*, 806 F.2d 368, 369 (2d Cir. 1986). Moreover, as the district court expressly found, the authorities on which Greenberg relies are plainly distinguishable from the circumstances presented in this case. *See* 1999 WL 642859 at *1. The arbitrators did not manifestly disregard the securities laws by refusing to impute

knowledge to Bear Stearns. They simply credited the testimony of Bear Stearns witnesses.

Greenberg's argument concerning allegedly "false confirmations" is equally infirm. The decision below correctly held that the arbitrators could have found the disputed language in the confirmations to be literally true. *See* 220 F.3d at 28. It was undisputed that Sterling Foster was an NASD market-maker in ML Direct securities; the statement in Greenberg's confirmations that Sterling Foster "makes a market in this security" therefore complied with the regulatory requirement that confirmations disclose "whether [the principal] is a market maker in the security." 17 C.F.R. § 240.10b-10(a)(2). In any event, the Petition here fails to address the other sufficient grounds for the arbitrators' rejection of this claim – including the absence of any evidence that Greenberg relied on the allegedly misleading confirmations, thereby causing his losses. *See Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 539 (2d Cir. 1999) (proof of "transaction" causation is an "essential" element of a securities fraud claim).

Finally, there is no foundation for Greenberg's assertion that the decision below failed to enforce 17 C.F.R. § 230.174 ("Rule 174"), which requires a "dealer" or "underwriter" of certain public offerings to deliver a prospectus in connection with sales of a newly issued security. The plain language of the regulation does not impose any duty upon clearing firms, and it was undisputed that Bear Stearns was not an issuer, underwriter or seller of ML Direct or any other relevant securities. Greenberg's alternative contention that Sterling Foster somehow delegated its duties under Rule 174 to Bear Stearns at most raised a factual issue concerning the terms of the relationship between Sterling Foster and Bear Stearns, and that issue was properly resolved by the arbitrators under ordinary principles of New York contract law. In short, none of the arguments in

the Petition remotely suggests a compelling legal question worthy of this Court's review.

IV. Before Reaching Any of the Foregoing Issues, This Court Would Have to Find Subject Matter Jurisdiction Over This Case.

Even if the Petition raised compelling issues for review, this Court could reach them only after determining whether the Second Circuit properly found subject matter jurisdiction over this case. The decision below focuses principally on this question, which concerns the scope of federal jurisdiction, absent diversity of citizenship, over petitions to vacate arbitration awards under FAA § 10. *See* 220 F.3d at 25-28. While none of the parties seeks this Court's review of the jurisdictional issue, it cannot be waived. Since the holding is disputable, it is possible that this Court might never reach the questions presented by the Petition.

The decision below did not disturb the well-settled principle that "the FAA does not confer subject matter jurisdiction on the federal courts even though it creates federal substantive law." *Id.* at 25 (citing *Southland Corp. v. Keating*, 465 U.S. 1, 16 n.9 (1984); *Moses H. Cone Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 n.32 (1983)). Rather, applying the jurisdictional analysis set forth in *Franchise Tax Board v. Construction Laborers Vacation Trust*, 463 U.S. 1, 27-28 (1983), the court below concluded that a petition to vacate under FAA § 10 raises a "substantial federal question" sufficient to confer jurisdiction "where, as here, the petitioner complains principally and in good faith that the award was rendered in manifest disregard of *federal* law." 220 F.3d at 27 (emphasis added). In the court's view, the "process" of determining whether the arbitrators manifestly disregarded federal law "so immerses the federal court in questions of federal law and their proper application that federal question subject matter jurisdiction is present." *Id.*

However, the Second Circuit frankly acknowledged that dicta in other cases suggest the potential for disagreement among federal courts concerning this holding. *See id.* at 27-28 (citing *Kasap v. Folger Nolan Fleming & Douglas, Inc.*, 166 F.3d 1243, 1247 (D.C. Cir. 1999) (suggesting that review for fraud under FAA § 10 implicates federal law but is insufficient to support federal jurisdiction); *Manginelli v. Smith Barney, Inc.*, No. 98 Civ. 8986, 1999 WL 615096, at *2 (S.D.N.Y. Aug. 12, 1999)). The jurisdictional decision below is not squarely in conflict with the law of any other circuit or this Court, and it therefore does not independently merit writ consideration. But given the potential obstacle it raises to review of the main questions presented here, this threshold issue constitutes another compelling reason to deny review of the Petition.

CONCLUSION

Petitioner's real quarrel with the decision below does not concern the standard of review applied, but rather the amply supported conclusion of both lower courts that the Award was not "irrational" or in manifest disregard of the law. There is no reason for this Court to undertake for a third time the conventional task of applying a well-established legal standard to the factual record of this case. Respondents respectfully submit that the Petition should be denied.

Respectfully submitted,

JACK P. LEVIN
COVINGTON & BURLING
1330 Avenue of the Americas
New York, New York 10019
(212) 841-1000

Attorney for Respondents Bear, Stearns & Co., Inc. and Bear, Stearns Securities Corp.

Of Counsel:

P. BENJAMIN DUKE

December 4, 2000

(3)

Supreme Court, U.S.
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No. 00-699

In The
Supreme Court of the United States

HOWARD GREENBERG,
Petitioner,

v.

BEAR, STEARNS & CO.,
BEAR STEARNS & CO., INC.,
BEAR STEARNS SECURITIES CORP.,
Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITIONER'S REPLY BRIEF

LESLIE TRAGER
Counsel of Record
MORLEY AND TRAGER
230 PARK AVENUE
NEW YORK, NY 10169
(212) 684-2210

Counsel for Petitioner

BECKER GALLAGHER LEGAL PUBLISHING, INC.,
CINCINNATI, OHIO 800-890-5001

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POINT I

CERTIORARI SHOULD BE GRANTED TO DETERMINE THE CORRECT STANDARD FOR REVIEW OF ARBITRATIONS UNDER THE FEDERAL SECURITIES LAWS.

Respondents' brief in opposition did not dispute that there is no standard as to what manifest disregard means. Nor did the respondents' brief discuss the desirability of having a standard which at least guaranteed that a reviewing court with respect to the federal securities laws could assure the parties that the basics of those laws had been applied.

As this case now stands, it is not an exaggeration to say that this case demonstrates that no law governs securities transactions before arbitrable forums. For this case shows that no matter how egregious and clear the violation, if three arbitrators in the industry-controlled forum decide there was no violation, that is the end of the matter.

Contrary to respondents' attempts to make this case look like an ordinary factual dispute in which reasonable men may differ, this case is about imputed knowledge as a matter of law.[1] The doctrine of imputed knowledge is admittedly totally accepted in the securities area. (See cases cited, p. 15 of petition to this Court.) Respondents' response to this is that:

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[1] Respondents first discuss this at page 13 of their brief. Point II of this brief will deal with respondents' "facts".

> The arbitrators did not manifestly disregard the securities law by refusing to impute knowledge to Bear Stearns. They simply credited the testimony of Bear Stearns' witnesses. (pp. 13, 14, respondents' brief)

That statement turns imputed knowledge on its head. The doctrine of imputed knowledge holds that as a matter of law, when a person or party is given certain facts in certain circumstances, that party is held to know them regardless of any testimony to the contrary. "The means of knowledge are the same thing in effect as knowledge itself." Dodds v. Cigna Securities Inc., 12 F.3d 346, 351 (2d Cir. 1993).

Moreover, the testimony was not even to the contrary, for the one witness (Brigley) who admitted to having seen the prospectus and who had admittedly read the first sentence of the one critical paragraph, said he could not "recall" reading the third sentence which would have clearly informed him of the lockup and the fraudulent misrepresentations. Thus, Brigley, when asked whether he had read the third sentence, stated at page A 138 (the page cited by respondents' brief at pages 3-4 for the proposition that "Bear Stearns' witnesses . . . did not read the technical language . . ."):

> Again, I don't know if I read it back then or remember reading it back then, but I certainly have seen it in subsequent times having to give testimony. (A 138, at p. 263)

Asked again about the third sentence Brigley stated: "I don't recall." (A 138, p. 264).

Not only did Brigley have this paragraph before him, but a Bear Stearns lawyer who drafted a personal guarantee

agreement from Sterling Foster's President with respect to this transaction, also had this page. Brigley testified that this lawyer wanted to know:

> where was the access of two million shares offered in the after market for selling security holders, so we sent that to her so she would have that page and the front page. (A 138)

In addition to these two people having this one paragraph, the number 2 managing director, Peter Murphy, was also shown this paragraph. Murphy couldn't "recall" anything about a lockup and the lawyer was not allowed to testify by the arbitrators over objection by claimant's attorney. Thus, if ever there were a case which required holding a company such as Bear Stearns liable for imputed knowledge, this is that case.

Respondents, in answer to petitioner's statement that the Second Circuit cited no authorities or gave any reasoning to support the conclusion that "it is by no means clear that the doctrine of imputed knowledge applies in this context", state:

> But the Petition simply ignores explicit case law (which Bear Stearns cited in its appellate brief) holding that knowledge of documents' contents should not be imputed to a financial entity performing high volume processing functions like those performed by clearing firms. See Woods v. Bank of New York, 806 F.2d 368, 369 (2d Cir. 1986)." (underlining added)

The problem with respondents' contention is that Bear Stearns cited to the Second Circuit only one inapplicable case

(Woods) and Bear Stearns was not performing a high-volume clearing function with respect to this case. As noted, Bear Stearns had asked for and examined the one applicable paragraph in the prospectus and obtained a personal guaranty from Sterling Foster's President with respect to this transaction. (A102, 200, 203) Thus, this was not a case involving massive documents flowing electronically through Bear Stearns, but was a carefully examined situation in which there was full discussion over this one paragraph in the prospectus.

Clearly, the Second Circuit did not cite Woods v. Bank of New York, supra, (the only case in respondents' brief to the Second Circuit on this Point) because it is so readily distinguishable and inapposite. The introductory paragraph in that case states:

> We . . . believe instead that to require a bank acting as transfer agent to look for notations on checks - - beyond those essential to its own requirements - - severely restricts the bank's everyday business by clogging the fast flow of information it must possess. Id. at 369

That case involved a notation on a check to put money into a particular fund. The court noted that the Bank of New York Mutual Fund made 45,000 payments per week in which clerks handled one payment every three minutes. Bear Stearns was not dealing with thousands of documents, but with one document, with one applicable paragraph in that document which at least one senior management member admitted reading in part.

Once Bear Stearns is deemed to have knowledge, Bear Stearns would be liable for participating in a fraudulent

scheme. Respondents' assertions that Bear Stearns had no duty to disclose is entirely irrelevant because it is basic law that if a party participates in its own self-created fraudulent scheme, it is that participation which imposes liability under the securities laws, not any duty to disclose. See U.S. v. Russo, 74 F.3d 1383. 1391, 1392 (2d Cir. 1996), cert. den. 117 S.Ct. 293.

As to the lack of disclosure in the confirmation of either the profit or the underwriting transaction, respondents say that there was no causal relationship shown for plaintiff's damages. This again is untrue because even the dumbest investor would understand that a 400% profit by a broker might be cause to worry. And, of course, knowledge of this 400% profit is imputed on the basis of the information available to Bear Stearns' managing director, who admittedly knew the price at which the stock was being sold to the public and who processed the sales to Sterling Foster by the selling shareholders at $3.25 a share. His denial of knowledge because he didn't do the math (dividing 1,000,000 into 3,000,000) should not pass muster under the doctrine of the imputed knowledge.

With respect to the failure to deliver a prospectus, respondents do not deny that Bear Stearns, in sending the confirmations in the first place, acted unlawfully since it is unlawful on a new issue to send any confirmation without a prospectus. Thus, this is not a question of delegation or contract law, but, rather, basic federal securities law. From that admitted violation everything else flows.

The courts so far, applying no articulated standards, have upheld this arbitration award. To say that the court will review for "manifest disregard" without any articulation of its meaning and where the result shows a failure to follow basic

federal securities law, renders meaningless petitioner's rights under the securities acts. Respondents' citation of First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 115 S.Ct. 1920 (1995) is not contrary to petitioner's argument because First Options merely cited Wilko v. Swan, 346 U.S. 427, 436-37, 74 S.Ct. 182 (1953) stating "parties bound by arbitrators' decision not in 'manifest disregard' of the law." Id. at 942; 1923. First Options never discussed the meaning of manifest disregard, much less its applicability to the securities laws.

Respondents also assert that the matters raised by petitioner "should be addressed to the SEC and the SROs, not this Court." (p. 10). But that is directly contrary to the promise made in Shearson/American Express v. McMahon, 482 U.S. 220, 232, 107 S.Ct. 2332, 2340 (1987) that there would be at least limited judicial review of arbitrations. Each individual shareholder is entitled to the protection of the federal securities laws and can only bring a claim before an industry-created arbitration panel. Review of such arbitration panel is entrusted to the courts, not the SEC or the SROs. Petitioner's remedy, therefore, can only lie with this Court.

POINT II

RESPONDENTS' STATEMENTS OF FACTS ARE NOT ONLY IRRELEVANT, THEY ARE INCORRECT.

Respondents state (p. 3) that "Bear Stearns obtained only a preliminary prospectus prior to the ML Direct offering and therefore did not know the contents of the final document." Of course, the final prospectuses was only issued on the day of the IPO. But Bear Stearns knew the fraudulent plans in advance. Thus, Brigley testified that in August,

1996, Adam Lieberman, President of Sterling Foster, called him and told him that immediately after the IPO for ML Direct, Sterling Foster was selling short 2.1 million shares and covering by "getting the shares from the selling shareholders" (A 109, p. 48). But the preliminary prospectus showed the 12-month lockup in the third sentence on page 2 for these shares.

Bear Stearns' statement that the shares in ML Direct were properly registered in a shelf registration is an irrelevant fact (p. 4). They were clearly registered, but they were also subject to a one-year lockup. Bear Stearns' next paragraph on page 4 states that the short position was merely a "technical deficit" and that:

> Bear Stearns typically received certificates for public offering shares *after* the shares had been sold to customers; as a result, temporary short positions in such circumstances were not abnormal but routine. (p. 4, respondents' brief)

If this transaction was so normal, one must ask why respondents' employees testified as follows:

> Brigley: I told him [Richard Primavera, a managing director] Sterling Foster was going to be participating in ML Direct and that it would be a large number of shares being traded, just give him heads-up, so when he sees a short position, he does not <u>have a heart attack about that</u>. (A114, at p. 67) (underlining added)

Mr. Primavera testified that his clerk, Mr. Cohen, had informed him of "a large short position". (A 239) During the days when this stock was short before the selling security holders had actually delivered, Brigley testified that he was "monitoring this... as closely as I could" (A 118, p. 84). He testified that his immediate superior, managing director Murphy, "would want to know where we were every day, how big is the customer debits, what is the short position, what does the overall entry look like in his account." (A 118, pp. 81-82) Further, he stated that he came in early to prepare e-mails and documentation so that Murphy could transmit this information to the number 1 person at Bear Stearns' clearing, Mr. Harriton, before 8:15 A.M. This was accomplished by Brigley sending e-mails marked "URGENT" before that time to Mr. Murphy, who in turn transmitted them to Mr. Harriton (A 118-119).

In addition, as noted, Sterling Foster's president signed a personal guarantee for the transaction prepared by Bear Stearns' lawyer and Sterling Foster also was required to place an additional $3 million in funds with Bear Stearns. (A 102, 103, pp. 20-23) The above facts demonstrate that the transaction here was anything but normal.

Bear Stearns next states that it did not know about the 400% profit because Bear Stearns denied that "anyone at Bear Stearns had attempted to compute Sterling Foster's purchase price for such shares" and that such knowledge would be irrelevant because "Bear Stearns could not determine whether other consideration not mentioned in the memoranda had been paid for the shares." (Respondents' brief, p. 5) See above for failure to do math issue.

As to the possibility of other consideration being paid,

this is irrelevant because once Bear Stearns knew that there was an apparent 400% profit (the difference between the $3.25 purchase price and the $15 sale price to the public), surely Bear Stearns would at least have to ask whether any other additional consideration was given. Bear Stearns did not do that. When the known facts show fraud, one doesn't avoid liability by claiming that there might be a possibility the transaction wasn't fraudulent without at least investigating. See Whitney v. Citibank, N.A., 782 F.2d 1106, 1116 (2d Cir. 1986) holding Citibank liable when "there were red flags flying all over the place."

POINT III

RESPONDENTS' JURISDICTION SUGGESTION.

Respondents raise the jurisdiction issue as a "potential obstacle . . . to review of the main questions presented here . . . . " (P. 16). Presumably, if *certiorari* were granted, respondents would argue as they did to the Second Circuit that there is no federal question jurisdiction even though the issues raised by the initial Petition to vacate the arbitration award all involved federal securities law issues.

The two federal acts involved - the Securities Act of 1933 and the Securities Exchange Act of 1934 - give jurisdiction and exclusive jurisdiction, respectively, to the federal courts. 15 U.S.C. §§ 77v; 78aa. Yet, respondents would argue that not only did Shearson/American Express relegate investors to industry arbitration, instead of federal court, but that it also took away from the federal courts any review of such arbitrations (when the federal laws are alleged to have been disregarded) except when diversity jurisdiction happens to exist. Presumably, respondents make such argument in good faith.

It would seem that if a question of jurisdiction can fairly exist when substantial federal claims are raised to the effect that the arbitrators disregarded the federal securities laws, then this Court should grant *certiorari* to resolve this issue as well.

CONCLUSION

This case demonstrates the present lawless of securities arbitration and the failure of the courts to insure the basic rights of those entitled to the protection of the federal securities laws. *Certiorari* should be granted to set standards for the courts to review these arbitrations so as to prevent such lawlessness.

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/s/_____
Leslie Trager (LT-8995)
Counsel of Record
MORLEY AND TRAGER
Attorneys for Petitioner
230 Park Avenue
New York, New York 10169
(212) 684-2210